

REPORT OF EXAMINATION  
OF THE  
GOLDEN BEAR INSURANCE COMPANY  
AS OF  
DECEMBER 31, 2003

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San Francisco, California  
August 26, 2004

Honorable John Garamendi  
Insurance Commissioner  
California Department of Insurance  
Sacramento, California

Dear Commissioner:

In accordance with your instructions, an examination has been conducted of the

**GOLDEN BEAR INSURANCE COMPANY**

(hereinafter referred to as the Company) at its home office located at 709 North Center Street, Stockton, California 95202.

**SCOPE OF EXAMINATION**

The last examination of the Company was made as of December 31, 1998. This examination covers the period from January 1, 1999 through December 31, 2003. The present examination included a review of the Company's practices and procedures, an examination of management records, tests and analyses of detailed transactions, an evaluation of assets, and a determination of liabilities as of December 31, 2003, as deemed necessary under the circumstances.

In addition to those items specifically commented upon in this report, other phases of the Company's operations were reviewed including the following areas that require no further comment: fidelity bonds and other insurance; officers', employees' and agents' welfare and pension plans; business in force by states; loss experience; and sales and advertising.

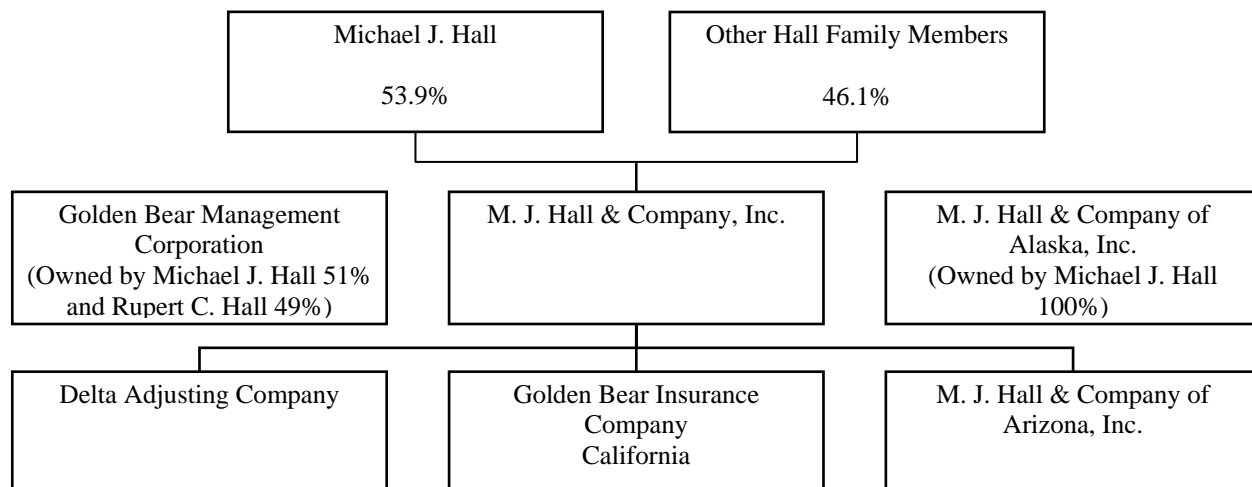
## COMPANY HISTORY

In September 1999, the Company affected a three-for-one stock dividend to meet the new minimum capital and surplus requirement. The Company transferred \$1.2 million from unassigned surplus to common capital stock.

In December 2002, the Company issued a \$2 million surplus note to its parent, M. J. Hall & Company, Inc., without the prior approval of the Commissioner as required by California Insurance Code (CIC) Section 1215.5(b), and, the Company failed to disclose this transaction in its 2002 Insurance Holding Company System Registration Statement as required by CIC Section 1215.4(b). In September 2003, the surplus note was converted into gross paid-in and contributed surplus. It is recommended that the Company obtain prior approval from the Commissioner before issuing any surplus notes in the future, and make disclosures required by CIC Section 1215.4(b).

## MANAGEMENT AND CONTROL

The Company is a member of an insurance holding company system, of which the ultimate controlling person is Michael J. Hall. Mr. Hall has a 53.9% ownership interest in M. J. Hall & Company, Inc., the immediate parent of the Company, with the balance being held by various members of the Hall family. The following chart depicts the interrelationship of the companies within the holding company system as of December 31, 2003 (all ownership is 100% unless otherwise indicated):



Management of the Company is vested in a seven-member board of directors. Following are lists of directors and the principal officers of the Company as of December 31, 2003:

#### Directors

##### Name and Residence

##### Principal Business Affiliation

Michael J. Hall  
Stockton, California

Chairman  
Golden Bear Insurance Company

Rupert C. Hall  
Stockton, California

President  
Golden Bear Insurance Company

John A. Quattrin  
Carmichael, California

Senior Vice President and Treasurer  
Golden Bear Insurance Company

Ashok B. Daftary  
Stockton, California

Physician

Peter G. Bernadicou  
Stockton, California

General Manger  
Unitrin, Inc.

Ronald M. Guntert, Jr.  
Stockton, California

President  
Guntert Steel

Simone L. Toccoli  
Stockton, California

Principal  
A.F. Toccoli & Sons

### Principal Officers

<u>Name</u>	<u>Title</u>
Rupert C. Hall	President
John A. Quattrin	Senior Vice President and Treasurer
Vinton J. Hawkins	General Counsel and Secretary

### Intercompany Agreements

An Accounting and Administrative Services Agreement was entered into between M. J. Hall & Company, Inc. (MJH) and the Company on September 28, 1987. Under this agreement, MJH provides all accounting services, including complete maintenance of the books of record and preparation of all accounting-related reports for the Company. MJH also provides various administrative services to the Company, including use of equipment.

A Claims Adjusting Services agreement was entered into between Delta Adjusting Company (Delta) and the Company on September 28, 1987. Under this agreement, Delta provides the Company with the claim adjustment services, including reviewing claim or loss reports made by insureds, conducting investigations on each reported claim or loss, arranging independent investigations or legal services, notifying all reinsurers of potential claims or losses, participating in negotiation and settlement of all claims subject to approval by the Company, performing administrative and clerical work in connection with claims or losses, and preparing administrative reports for management. Fees for these services are \$55 per hour for adjuster services and \$20 per hour for clerical services.

A Federal Income Tax Sharing Agreement was entered into between the Company, MJH, M. J. Hall & Company of Arizona, Inc. (MJH-AZ) and Delta. This agreement was executed on July 21, 1987. Under this agreement, MJH will file a consolidated federal income tax return on behalf of the other companies. Federal income taxes are paid or recovered on the basis of each company's federal taxable income or loss.

An Allocation of Operating Expenses Agreement was entered into between the Company and the other companies within the MJH holding company system on July 22, 1987. These companies include MJH, MJH-AZ, M. J. Hall & Company of Alaska, Inc., and Delta. Under this agreement, certain operating costs that are incurred by one company but provide benefits to other companies will be allocated to the other companies based on a formula. Expenses qualifying for allocation may include payroll, advertising, insurance, travel and entertainment, accounting and legal, printing and supplies, and automobile.

It is recommended that the Company amend the Accounting and Administrative Services and the Allocation of Operating Expenses agreements to reflect all of the services provided and a reasonable allocated cost basis for those services and include substantive safeguard provisions. Net amounts due or payable should be settled within 30 days. Once the agreements have been amended, it is recommended that they be submitted to the California Department of Insurance for approval in accordance with CIC Section 1215.5(b) (4). Similar comments were made in the prior examination report.

#### CORPORATE RECORDS

Some officers and directors did not have a signed conflict of interest statement on file for some years of the examination period. It is recommended that the Company take measures to ensure that all officers and directors properly and timely complete a conflict of interest statement each year.

#### TERRITORY AND PLAN OF OPERATION

The Company specializes in commercial lines insurance written primarily in California. The Company also writes property and casualty business in Hawaii and casualty only business in Arizona. The Company is licensed in California and Arizona and operates as a nonadmitted insurer in Hawaii.

Direct premiums written during 2003 were \$34.2 million, of which other liability accounted for 56.0%, earthquake 23.9%, fire 9.4%, commercial auto liability 8.9%, and homeowners multiple peril 1.8%. The Company also assumed premiums of \$5.1 million during 2003.

The lines of business written by the Company include other liability – occurrence, earthquake, commercial auto liability, fire, and homeowners multiple peril. The majority of the business written by the Company consists of primary general liability policies with coverage up to \$1 million and excess and umbrella policies over underlying limits, generally \$500,000. The earthquake coverage is for commercial property, and is written on a monoline basis using a difference in conditions (DIC) form with policies issued yearly. The commercial automobile liability currently being written is excess/umbrella coverage only.

In 2000, the Company began writing a book of assumed reinsurance business. The assumed business is primarily on other liability insurance. An affiliated company, Golden Bear Management Corporation (GBMC), is producing this business, using the Company's underwriting criteria, in the western United States where the Company is not licensed. All policies are issued by North America Capacity Insurance Company or North America Specialty Insurance Company (both are subsidiaries of Swiss Reinsurance America) that are reinsured by Swiss Reinsurance America, and the net retained limits are retro-ceded to the Company. In 2002, the Company began writing homeowners insurance in California.

Business is marketed through approximately 65 wholesale brokerage firms. During 2003, 22.2% of the direct premiums written were produced by the parent, M. J. Hall & Company, Inc., including 100% of the homeowners multiple peril policies. Additionally, 100% of the assumed business was produced by an affiliate, GBMC.

#### GROWTH OF COMPANY

During the examination period the Company experienced substantial premium growth. Direct premiums written have grown from \$11.1 million in 1998 to \$34.2 million in 2003. All lines of business experienced growth; however, the other liability – occurrence line of business



experienced the most growth. This increase is due both to an increased number of risks written and higher premium rates.

## REINSURANCE

### Assumed

The Company assumes a book of business under a fronting arrangement whereby the Company assumes the net retention of the business produced by an affiliate (Golden Bear Management Corporation) using the Company's underwriting guidelines. Policies on the assumed business are issued using North America Capacity Insurance Company or North America Specialty Insurance Company policies that are reinsured by Swiss Reinsurance America, and the net retained limits are retro-ceded to the Company.

<u>Type of Contract</u>	<u>Ceding Company</u>	<u>Ceding Company's Retention</u>	<u>Company's Limits</u>
<b><i>Umbrella Quota Share Retrocession</i></b>	Swiss Reinsurance America, Inc.	85% of first \$1 million per occurrence or 95% of first \$1 million if underlying policy is assumed by the Company.  100% of next \$4 million per occurrence.	15% of first \$1 million per occurrence or 5% of first \$1 million per occurrence if underlying policy is assumed by the Company.
<b><i>Casualty Retrocession Excess of Loss</i></b>	Swiss Reinsurance America, Inc.	First layer: \$400,000 excess of \$100,000, per occurrence.  Second layer: \$1.5 million excess of \$500,000, per occurrence.	First layer: \$100,000 per occurrence.  Second layer: 100% of amounts in excess of \$2 million, per occurrence.

## Ceded

<u>Type of Contract</u>	<u>Reinsurer</u>	<u>Company's Retention</u>	<u>Reinsurer's Maximum Limit</u>
<b><i>Casualty Excess of Loss</i></b>			
First Layer	Swiss Reinsurance America, Inc.	\$100,000 each occurrence	\$400,000 excess of \$100,000, each occurrence
Second Layer	Swiss Reinsurance America, Inc.	\$500,000 each occurrence	\$1.5 million excess of \$500,000, each occurrence
<b><i>Umbrella Liability Quota Share</i></b>			
First Layer	Swiss Reinsurance America, Inc.	15% of first \$1,000,000	85% of first \$1 million or 95% of first \$1 million if the Company writes underlying policy
Second Layer	Swiss Reinsurance America, Inc.	None	100% of next \$4 million
<b><i>Property Per Risk Excess of Loss</i></b>			
	General Reinsurance Corporation – 65% Swiss Reinsurance America, Inc. – 35%	\$150,000 each risk	\$850,000 excess of \$150,000 each risk, occurrence limit of \$5.1 million
<b><i>Property Catastrophe Excess of Loss</i></b>			
First Layer	General Reinsurance Corporation	\$300,000 each occurrence	\$700,000 excess of \$300,000 each occurrence
Second Layer	General Reinsurance Corporation	\$1 million each occurrence	\$2 million excess of \$1 million each occurrence
Third Layer	General Reinsurance Corporation	\$3 million each occurrence	\$4 million excess of \$3 million each occurrence
Fourth Layer	General Reinsurance Corporation	\$7 million each occurrence	\$8 million excess of \$7 million each occurrence
Fifth Layer	General Reinsurance Corporation	\$15 million each occurrence	\$5 million excess of \$15 million each occurrence
<b><i>Property Surplus 100% Surplus Share</i></b>			
	General Reinsurance Corporation – 50% Swiss Reinsurance America, Inc. – 30% American Re-insurance Company – 10% QBE Reinsurance Corporation – 10%	None	\$4 million any one risk, occurrence limit of \$25 million and maximum of \$40 million any one event.
<b><i>Homeowners Property Per Risk Excess of Loss</i></b>			
Property Coverage	General Reinsurance Corporation	\$50,000 any one loss	\$700,000 excess of \$50,000 any one loss
Liability Coverage	General Reinsurance Corporation	\$50,000 any one loss	\$450,000 excess of \$50,000 any one loss

Some of the ceded reinsurance agreements contain an insolvency clause that does not comply with California Insurance Code (CIC) Section 922.2(a)(2). Also, the insolvency clause in these ceded reinsurance agreements also contains references to New York insurance law. It is recommended that the Company amend its reinsurance agreements to meet the requirements of CIC Section 922.2(a)(2) and remove any reference to New York laws.

The offset clause in several of the ceded reinsurance agreements was found to be unacceptable because it mentions “insolvency” and has references to New York insurance laws. By including “insolvency” in an offset clause, it places the offset clause in the context of an insolvency setting and negates the provisions of the insolvency clause (which requires the reinsurer to pay its portion of the loss without diminishment). In addition, any references to any laws other than that of the State of California do not belong in a reinsurance agreement where the ceding company is a California domestic, since the only applicable laws are those of the State of California. It is recommended that the reinsurance agreements be amended to remove any reference to “insolvency” or New York laws from the offset clause.

Several of the reinsurance contracts contain a special termination provision which permit early termination of the contract in the event of a court order for the conservation, rehabilitation, liquidation or appointment of a receiver of the Company. Per SSAP No. 62, paragraph 7, an entry of an order of rehabilitation or liquidation cannot constitute an anticipatory breach by the reporting entity nor be grounds for retroactive revocation or retroactive cancellation of any contracts of the reporting entity. It is recommended that the reinsurance agreements be amended to comply with SSAP No. 62, paragraph 7, of the NAIC Accounting Practices and Procedures Manual.

The arbitration clause in some of the reinsurance agreements permits the arbitrators to avoid a “strict” interpretation of substantive and procedural law. This could operate to negate the statutory insolvency clause, and so it is recommended that the reinsurance agreements be amended to provide an exception for the insolvency clause in the arbitration clause.

## ACCOUNTS AND RECORDS

### Information Systems Control Environment

A limited review was made of the Company's general controls over its information systems. It was noted that the Company does not have a written and tested disaster recovery and business continuity plan. It is recommended that the Company prepare a written disaster recovery and business continuity plan.

### Claims and Reserving Practices

It was noted that the Company does not have a handbook or manual that outlines the claims handling procedures or policies for its staff. It is recommended that the Company develop a formal claims-handling procedures manual.

The Company has a practice of using the policy effective date as the date of loss for claims where the date of loss is unknown or undeterminable. Additionally, the policy effective date is also used when a loss occurs outside the policy effective period because the Company's claims system does not allow the entry of a loss date outside the policy period. Such practices are inappropriate because it can skew the loss triangles and the development of losses, and create inaccuracies in the Schedule P. It is recommended that the Company put more effort in determining an appropriate date of loss instead of using the policy effective date. Also, it is recommended that the Company use the date of discovery as the date of loss when an exact date of loss cannot be determined.

A review was made of the unpaid claims for loss reserve adequacy, and some instances were noted where a claim was under-reserved at December 31, 2003 despite documentation in the claim file that warranted higher reserves. Although the overall loss and loss adjustment expense reserves appear to be adequate, it is recommended that the Company put in a good faith effort in evaluating the liability of each claim and establish sufficient reserves on a case basis.

## FINANCIAL STATEMENTS

The financial statements prepared for this examination report include:

Statement of Financial Condition as of December 31, 2003

Underwriting and Investment Exhibit for the Year Ended December 31, 2003

Reconciliation of Surplus as Regards Policyholders from December 31, 1998 through  
December 31, 2003

Reconciliation of Examination Changes as of December 31, 2003

Statement of Financial Condition  
as of December 31, 2003

	<u>Ledger and Non-ledger Assets</u>	<u>Non- Admitted Assets</u>	<u>Net Admitted Assets</u>	<u>Notes</u>
<u>Assets</u>				
Bonds	\$28,648,841	\$	\$28,648,841	(1)
Stocks:				
Preferred stocks	258,200		258,200	(1)
Common stocks	3,706,670		3,706,670	(1)
Cash and short-term investments	8,847,605	573,712	8,273,893	(1)
Other invested assets	47,473		47,473	
Receivable for securities	73,248		73,248	
Investment income due and accrued	484,069		484,069	
Agents' balances or uncollected premiums:				
Premiums and agents' balances in course of collection	3,722,600	185,056	3,537,544	(2)
Reinsurance:				
Amounts recoverable from reinsurers	104,948		104,948	
Other amounts receivable under reinsurance treaties	1,353,799		1,353,799	
Net deferred tax asset	872,661		872,661	
Electronic data processing equipment	135,089	135,089		
Furniture and equipment	115,341	115,341		
Receivable from parent, subsidiaries, and affiliates	13,779		13,779	
Equities in deposits in pools and associations	<u>77,526</u>		<u>77,526</u>	
Total assets	<u>\$48,461,849</u>	<u>\$1,009,198</u>	<u>\$47,452,651</u>	
<u>Liabilities, Surplus and Other Funds</u>				
Losses			\$14,314,856	(3)
Loss adjustment expenses			4,294,936	(3)
Other expenses			696,223	
Taxes, licenses, and fees			293,124	
Federal and foreign income taxes			850,000	
Unearned premiums			9,286,169	
Ceded reinsurance premiums payable			<u>7,083,367</u>	
Total liabilities			36,818,675	
Common capital stock		\$1,800,000		
Gross paid-in and contributed capital		3,773,978		(4)
Unassigned funds		<u>5,059,998</u>		
Surplus as regards policyholders			<u>10,633,976</u>	
Total liabilities, surplus and other funds			<u>\$47,452,651</u>	

Underwriting and Investment Exhibit  
for the Year Ended December 31, 2003

Statement of Income

Underwriting Income

Premiums earned		\$18,555,735
Deductions:		
Losses incurred	\$8,280,051	
Loss expenses incurred	2,403,543	
Other underwriting expenses incurred	<u>4,353,981</u>	
Total underwriting deductions		<u>15,037,575</u>
Net underwriting gain		3,518,160

Investment Income

Net investment income earned	\$1,317,794	
Net realized capital gains	<u>68,415</u>	
Net investment gain		1,386,209

Other Income

Net loss from agents' or premium balances charged off	<u>\$ (40,569)</u>	
Total other income		<u>(40,569)</u>
Net income before federal income taxes		4,863,800
Federal income taxes incurred		<u>2,051,151</u>
Net income		<u><u>\$2,812,649</u></u>

Capital and Surplus Account

Surplus as regards policyholders, December 31, 2002		\$7,279,528
Net income	\$2,812,649	
Change in net unrealized capital gains	890,696	
Change in unrealized foreign exchange capital gains	115,881	
Change in net deferred income tax	147,661	
Change in nonadmitted assets	(612,439)	
Change in surplus notes	(2,000,000)	
Change in paid-in capital	<u>2,000,000</u>	
Change in surplus as regards policyholders for the year		<u>3,345,448</u>
Surplus as regards policyholders, December 31, 2003		<u><u>\$10,633,976</u></u>

Reconciliation of Surplus as Regards Policyholders  
from December 31, 1998 through December 31, 2003

Surplus as regards policyholders, December 31, 1998, per Examination			\$3,824,946
	<u>Gain in</u> <u>Surplus</u>	<u>Loss in</u> <u>Surplus</u>	
Net income	\$5,119,595	\$	
Net unrealized capital gains	142,305		
Change in unrealized foreign exchange capital gains	156,941		
Change in deferred income tax	862,661		
Change in nonadmitted assets		967,803	
Change in provision for reinsurance	17,331		
Change in surplus notes		150,000	
Change in paid in capital	2,000,000		
Capital changes - Transferred from surplus	1,200,000		
Surplus adjustments - Transferred to capital		1,200,000	
Dividends to stockholders	<u>                    </u>	<u>372,000</u>	
Totals	<u>\$9,498,833</u>	<u>\$2,689,803</u>	
Net increase in surplus as regards policyholders			<u>6,809,030</u>
Surplus as regards policyholders, December 31, 2003, per Examination			<u>\$10,633,976</u>



Reconciliation of Examination Changes  
as of December 31, 2003

<u>Account</u>	<u>Per Company</u>	<u>Per Examination</u>	<u>Surplus Increase (Decrease)</u>	<u>Notes</u>
Cash and short-term investments	\$8,847,605	\$8,273,893	<u>\$ (573,712)</u>	(1)
Net decrease to surplus, per examination			(573,712)	
Surplus as regards policyholders, December 31, 2003, per Company			<u>11,207,688</u>	
Surplus as regards policyholders, December 31, 2003, per Examination			<u>\$10,633,976</u>	

## COMMENTS ON FINANCIAL STATEMENT ITEMS

### (1) Bonds, Preferred Stocks, Common Stocks, and Cash and Short-term Investments

California Insurance Code (CIC) Section 1104.9 requires that securities and moneys be deposited in a qualified custodian or qualified depository; that such deposits be authorized by an agreement between the insurer and the qualified custodian; and be approved by the Commissioner. The Company's bonds, preferred stocks, common stocks, and short-term investments are deposited with Union Safe Deposit Bank (USDB), an entity that does not meet the qualified custodian requirements of CIC Section 1104.9. The custodial agreement between the Company and USDB was not approved by the Commissioner. It is recommended that the securities and funds on deposit with USDB be moved to a qualified custodian, and that the Company submit a new custodial agreement for approval to the California Department of Insurance as soon as possible.

The Company has a \$390,000 money market fund on deposit with UBS Financial Services, Inc. (UBS). UBS is not a qualified custodian, and does not have an approved custodial agreement with the Company. It is recommended that the Company comply with CIC Section 1104.9.

At December 31, 2003, \$3.8 million in bonds were held in a trust account in accordance with the terms of the reinsurance agreements covering the business assumed from Swiss Re America Corporation. The funds in the trust account are to be used for payment of losses and loss adjustment expenses resulting from the business assumed. The trustee for the trust account is Union Safe Deposit Bank.

There are several dozen securities in the Company's bond portfolio that have been designated by the Company as NAIC Class 1, but were not rated by the NAIC Securities Valuation Office (SVO), and were not submitted to the SVO to be rated and valued. It is recommended that these securities either be filed with the SVO or, designated as "provisionally exempted (PE)" if they meet the conditions for provisional exemption under the NAIC SVO Manual.

It was noted that the Company does not have formal procedures for identifying long outstanding unpaid cash items and escheating such items to the State in accordance with the Unclaimed Property Law (commencing with Section 1500 of the California Code of Civil Procedure). It is recommended that the Company adopt formal procedures to identify and report such items in accordance with the unclaimed property laws of applicable states.

The Company has two investments in foreign countries which do not qualify as admitted assets under CIC Section 1241(c). The foreign investments include a term deposit with a New Zealand bank and an investment account (debenture stock) with an Australian finance/investment company. Under CIC Section 1241(c), investments in foreign countries may be admitted only if the securities are listed or traded on a securities exchange subject to regulation, supervision or control under a statute of the USA, or be subject to annual review by the NAIC Evaluation Committee. The two foreign investments are not the type of investment that would normally be traded on a securities exchange nor subjected to annual reviewed by the NAIC Evaluation Committee. The aggregate book value of the two foreign investments is \$573,712. An examination adjustment was made to nonadmit the two foreign investments.

## (2) Agents' Balances and Uncollected Premiums

The Company partially offsets its overdue premiums with credit balances of unrelated policyholders. SSAP No. 6, paragraph 9 only allows for credit balances over 90 days due to be offset against positive balances for the same policyholder. It is recommended that the Company not offset credit balances over 90 days due of one policyholder with debit balances over 90 days due of another policyholder in accordance with SSAP No. 6, paragraph 9. The amount was not material, and no examination adjustment was made.

## (3) Losses and Loss Adjustment Expenses

The California Department of Insurance (CDI), pursuant to CIC Section 733(g), retained an independent actuary for the purpose of providing a full actuarial evaluation of the Company's loss and loss adjustment expense reserves as of December 31, 2003. Based on the evaluation and

the review of the work by a Casualty Actuary from the CDI, the Company's December 31, 2003 reserves for losses and loss adjustment expenses were determined to be reasonably stated and have been accepted for purposes of this examination.

(4) Surplus Note and Paid-in Surplus

On December 16, 2002, the Company issued a \$2 million surplus note to its parent, M. J. Hall & Company, Inc. (MJH), without the approval from the Commissioner as required by CIC Section 1215.5. On September 10, 2003, the Company liquidated the surplus note and MJH reinvested the \$2 million as gross paid-in and additional contributed surplus.

SUMMARY OF COMMENTS AND RECOMMENDATIONS

Current Report of Examination

Company History (Page 2): It is recommended that any future surplus notes be submitted to the California Department of Insurance (CDI) for approval in accordance with California Insurance Code (CIC) Section 1215.5(b), and be disclosed in the Insurance Holding Company System Registration Statement in accordance with CIC Section 1215.4(b).

Management and Control – Intercompany Agreements (Page 4): It is recommended that the Company amend the agreements to reflect all of the services provided and a reasonable allocated cost basis for those services and include substantive safeguard provisions, and be submitted to the CDI for approval in accordance with CIC Section 1215.5(b)(4).

Corporate Records (Page 5): It is recommended that the Company take measures to ensure that all officers and directors properly and timely complete a conflict of interest statement each year.

Reinsurance – Ceded (Page 8): It is recommended that the reinsurance agreements be amended to meet the requirements of CIC Section 922.2(a) (2) and remove any reference to New York laws from the insolvency clause.

It is recommended that the reinsurance agreements be amended to remove any reference to “insolvency” or New York laws from the offset clause.

It is recommended that the reinsurance agreements be amended to comply with SSAP No. 62, paragraph 7, of the NAIC Accounting Practices and Procedures Manual.

It is recommended that the reinsurance agreements be amended to provide an exception for the insolvency clause in the arbitration clause.

Accounts and Records – Information Systems Control Environment (Page 10): It is recommended that the Company prepare a written disaster recovery and business continuity plan.

Accounts and Records – Claims and Reserving Practices (Page 10): It is recommended that the Company develop a formal claims-handling procedures manual.

It is recommended that the Company put more effort in determining an appropriate date of loss instead of using the policy effective date. Also, it is recommended that the Company use the date of discovery as the date of loss when an exact date of loss cannot be determined.

It is recommended that the Company put in a good faith effort in evaluating the liability of each claim and establish sufficient reserves on a case basis.

Comments on Financial Statement Items – Bonds, Stocks, and Cash and Short-term Investments (Page 16): It is recommended that the securities and funds on deposit with Union Safe Deposit Bank and UBS Financial Services, Inc. be moved to a qualified custodian, and that the Company submit a new application for approval to the CDI as soon as possible in accordance with CIC Section 1104.9.

It is recommended that the Company file its securities with the NAIC Securities Valuation Office (SVO) to be rated and valued or, designate the securities as “provisionally exempted (PE)” if they meet the conditions for provisional exemption under the NAIC SVO Manual.

It is recommended that the Company adopt formal procedures to identify and report such items in accordance with the unclaimed property laws of applicable states.

The Company has two investments in foreign countries which do not qualify as admitted assets under CIC Section 1241(c).

Comments on Financial Statement Items – Agents’ Balance and Uncollected Premiums (Page 17): It is recommended that the Company not offset credit balances over 90 days due of one policyholder with debit balances over 90 days due of another policyholder in accordance with SSAP No. 6, paragraph 9.

#### Prior Report of Examination

Company History (Page 2): It was recommended that any future surplus notes be submitted to the CDI for approval. The Company did not obtain approval from the CDI for the surplus note that was issued to the parent company in December 2002.

Management and Control (Page 4): It was recommended that the Company amend the agreements to reflect all of the services provided and a reasonable allocated cost basis for those services and include substantive safeguard provisions. The Company has not amended the agreements.

It was recommended that the Company comply with CIC Section 1215.5 and file the registration statement annually. The Company is now in compliance.

Corporate Records (Page 4): It was recommended that the Company comply with CIC Section 1201. The Company is now in compliance.

Reinsurance (Pages 5): It was recommended that the Company amend its reinsurance agreements to meet the requirements of CIC Section 922.2(a) (2). Some reinsurance agreements still are not in compliance with CIC Section 922.2(a) (2).

It was recommended that the reinsurance agreement be amended to comply with Chapter 22 of the NAIC Accounting Practices and Procedures Manual. During the current examination period, some reinsurance agreements still do not comply with SSAP No. 62 (formerly known as Chapter 22) because the agreements have an unacceptable insolvency clause and allow early termination of the agreement on an order of rehabilitation or liquidation.

Comments on Financial Statement Items – Bonds and Stocks (Page 12): It was recommended that the Company submit its securities to the SVO for valuation. The Company still has securities that have not been submitted to the SVO.

Comments on Financial Statement Items - Cash (Page 12): It was recommended that checks outstanding for over six months be removed from the outstanding list and reclassified to a liability account for unclaimed funds to be later escheated to the proper states. Also, it was recommended the Company adopt a formal procedure with respect to unpaid cash items and to the reporting of such items in accordance with the unclaimed property laws of the applicable states. The Company has not adopted a formal escheat procedure.

Comments on Financial Statement Items – Premiums and Agents' Balances in Course of Collection (Page 12): It was recommended that the Company not offset credit balances over 90 days due of one policyholder with debit balances over 90 days due of another policyholder. The Company continues its practice of offsetting overdue debit balances of unrelated policyholders.

Comments on Financial Statement Items - Electronic data processing equipment (Page 12): It was recommended the Company comply with CIC Section 1194.95. Electronic data processing equipment is now nonadmitted.

## ACKNOWLEDGEMENT

Acknowledgment is made of the cooperation and assistance extended by the Company's officers and employees during the course of this examination.

Respectfully submitted,

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Ber Vang, CFE  
Examiner-In-Charge  
Associate Insurance Examiner  
Department of Insurance  
State of California